Office of Chief Counsel
Internal Revenue Service

memorandum

CC:WR:SCA:LN:TL-N-6289-98
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date: FEB 0 8 1999

to: Chief, Examination Division, Southern California District
Attention: Susan Downing, International Examiner
Examination Group SP 1410, Laguna Niguel

from: Southern California District Counsel, Laguna Niguel
June Y. Bass, Assistant District Counsel
Paul B. Burns, Special Litigation Assistant PBB

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subject: Advisory Opinion re Abatement of Penalties under I.R.C. Section 6038A
Taxpayer: [redacted]
Taxable Years Ended September 30, [redacted], September 30, [redacted] and September 30, [redacted]
Our File No. TL-N-6289-98

THIS ADVICE CONSTITUTES RETURN INFORMATION SUBJECT TO I.R.C. SECTION 6103. THIS ADVICE CONTAINS CONFIDENTIAL INFORMATION SUBJECT TO THE ATTORNEY-CLIENT AND DELIBERATIVE PROCESS PRIVILEGES AND (IF PREPARED IN ANTICIPATION OF LITIGATION) SUBJECT TO THE ATTORNEY WORK PRODUCT PRIVILEGE. ACCORDINGLY, THE EXAMINATION OR APPEALS RECIPIENT(S) OF THIS DOCUMENT MAY PROVIDE IT ONLY TO THOSE PERSONS WHOSE OFFICIAL TAX ADMINISTRATION DUTIES WITH RESPECT TO THIS CASE REQUIRE SUCH DISCLOSURE. IN NO EVENT MAY THIS DOCUMENT BE PROVIDED TO EXAMINATION, APPEALS, OR OTHER PERSONS BEYOND THOSE SPECIFICALLY INDICATED IN THIS STATEMENT. THIS ADVICE MAY NOT BE DISCLOSED TO TAXPAYERS OR THEIR REPRESENTATIVES.

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At your request, we have reviewed your memorandum dated [redacted] to [redacted] In your memorandum, you set forth the reasons for your decision to deny [redacted] request for abatement of non-compliance penalties under I.R.C. Section 6038A.

For the reasons set forth below, it is our opinion that with the exception of the penalties asserted with respect to failures to file Forms 5472 with respect to [redacted] and [redacted], the proposed penalties should be abated.[1]

FACTS

We understand the relevant facts to be as follows.[2]

[redacted] is a California corporation with its principal office in [redacted] California. During the taxable years at issue, [redacted] was the common parent of an affiliated group of corporations which filed consolidated United States Federal income tax returns. At all times relevant to this case, [redacted] was a wholly-owned subsidiary of [redacted] a Japanese corporation ("[redacted]").

During the taxable years at issue, [redacted] principal business activity was the distribution and sale in the United States of [redacted]. In the course of this activity, [redacted] engaged in a wide variety of transactions with [redacted] and other foreign and domestic corporations which are controlled by [redacted].

Based on your analysis of the transactions between [redacted] (on the one hand) and [redacted] and other members of the [redacted] group of companies (on the other) you determined that [redacted] should have: (1) attached [redacted] Internal Revenue Service Forms 5472 to its consolidated Form 1120 for the taxable year ended September 30, [redacted] (2) attached [redacted] Internal Revenue Service Forms 5472 to its consolidated Form 1120 for the taxable year ended September 30, [redacted] and (3) attached [redacted] Internal Revenue Service Forms 5472 to its consolidated Form 1120 for the taxable year ended September 30, [redacted]. In fact, when those consolidated Forms 1120 were filed, [redacted] attached [redacted], [redacted] and [redacted] Forms 5472, respectively. You determined that penalties for

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[1] The opinions, conclusions, and recommendations set forth in this memorandum have been coordinated with and approved by the office of the Associate Chief Counsel (International).

[2] Our understanding of the facts of this case is limited to the facts set forth in your memorandum to [redacted] and in a letter dated [redacted] from [redacted] of [redacted] to the director of the [redacted] Service Center, which letter is captioned "Request for Abatement of Penalties." We have not undertaken any independent investigation of the facts of this case. If the actual facts were to be different from the facts known to us, our legal analysis and our conclusions and recommendations might be different. Accordingly, if you learn that the facts known to us are incorrect or incomplete in any material respect, you should not rely on the opinions set forth in this memorandum, and should contact our office immediately.

failure to file Forms 5472 should be assessed, in the amounts of $[redacted] $[redacted] and $[redacted] respectively.

In its [redacted] letter to the [redacted] Service Center, [redacted] effectively admitted that your determination that it failed to file Forms 5472 that it was obligated to file was correct. However, it claimed that the penalties should be abated, because the failures to file were due to reasonable cause.

In support of its request, [redacted] noted that in the taxable years ended September 30, [redacted] and September 30, [redacted] all but two of the Forms 5472 which it admittedly failed to file related to domestic corporations. It claims that it failed to file Forms 5472 with respect to domestic corporations based on its understanding of the instructions for Form 5472, which it claims were ambiguous and confusing. With respect to the two foreign corporations for which Forms 5472 were not filed ([redacted] failed to file Forms 5472 with respect to [redacted] and [redacted] for the taxable year ended September 30, [redacted], it claims that the failure to file was due to "inadvertent administrative error," and goes on to say that

> ... [redacted] the parent company and [redacted]% shareholder, has many affiliates all over the world. Many of these affiliates are not known to [redacted] and it is very difficult to keep track of all the different transactions with them. Consequently, there may be instances where [redacted] and its subsidiaries may not be aware that it is transacting with a related foreign corporation which is what occurred in this instance.

In your memorandum, you noted that [redacted] has filed Forms 5472 with respect to [redacted] for taxable years prior to the taxable year ended September 30, [redacted]

For the taxable year ended September 30, [redacted] [redacted] failed to file Forms 5472 with respect to [redacted] and [redacted] In each case, Form 5472 was timely filed for the taxable year ended September 30, [redacted] In its request, [redacted] states that the failure to file Form 5472 for [redacted] is due to "inadvertent administrative error." No explanation is given for the failure to file Form 5472 for [redacted]

The matter is now being considered by Appeals.

LEGAL ANALYSIS

I.R.C. Section 6038A(d)(1) provides generally that if a reporting corporation (as defined in Section 6038A(a)) fails to file a Form 5472 that is required to be filed, a penalty is imposed. For

taxable years beginning on or before July 10, 1989, the penalty was $1,000 for each failure; for taxable years beginning after July 10, 1989, the penalty was increased to $10,000 for each failure. *See also* Treas. Reg. § 1.6038A-4(a)(3).

I.R.C. Section 6038A(d)(3) provides that the time for filing "... shall be treated as not earlier than the last day on which (as shown to the satisfaction of the secretary) reasonable cause existed for failure to furnish the information ..."This means that if there was reasonable cause for failure to file at the time the Form 5472 would otherwise have been due, no penalty will be imposed until there is no longer reasonable cause not to file (as, for example, when the Service notifies a taxpayer that it failed to file a Form 5472 which it should have filed).

The Regulations under I.R.C. Section 6038A elaborate on the definition of reasonable cause. In determining whether reasonable cause exists or existed, all of the relevant facts and circumstances are to be taken into account. Treas. Reg. § 1.6038A-4(b)(2)(iii). "Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of the experience and knowledge of the taxpayer." *Id.*

In this case, [redacted] claims that it failed to file Forms 5472 for related parties which were domestic corporations not included in its consolidated return because the ambiguous instructions to the form led it to reasonably believe that it was not required to file Forms 5472 with respect to those entities. Our research has not revealed any cases which have addressed this issue under I.R.C. Section 6038A. However, it is our opinion that although the matter is not free from doubt, it is more likely than not that a court would conclude that [redacted] has shown reasonable cause.

We agree that the instructions for the version of Form 5472 that was in use during the taxable years ended September 30, [redacted] and September 30, [redacted] are ambiguous.[3] The general instructions state that "[f]or purposes of form 5472, a 'related party' is *any* party related to the reporting corporation within the meaning of section 267(b) or section 707(c)(1). The term includes any other related person who is defined in section 482." (emphasis added). However, in at least three places, the form arguably could be read to require reporting only for foreign entities. First, the specific instructions for Part I, line 2, state: "A separate Form 5472 must be submitted by the reporting corporation for each *foreign* person who is a related party." (Emphasis added). Second, the specific instructions for Part III state: "Generally, all the reportable transactions between the reporting corporation and a related *foreign* person must be entered on Form 5472." (Emphasis added). Third, the form itself calls for specific identification of only those transactions entered into with foreign related parties (see Parts III and IV), with no clarification that the

[3] A copy of the form and the instructions is attached to this memorandum and marked as Exhibit A.

remainder of the form must be completed and submitted even if the reporting corporation's only transactions were with domestic related parties.[4]

We think that a taxpayer of the size and sophistication of [redacted] should have consulted the regulations to resolve the ambiguity in the instructions for the form.[5] There is no evidence that it did so. However, the Regulations cannot be said to be clear and unambiguous. Regulations Section 1.6038A-1(c)(1) did state that Form 5472 filing requirements potentially applied to transactions with "each related corporation (whether domestic or foreign)," but the same sentence specified that the "return on Form 5472 shall contain such information as the form shall prescribe...." Thus, the regulations ultimately referred back to the form and its concomitant ambiguities.

For these reasons, it is our opinion that [redacted] has shown reasonable cause for its failure to file Forms 5472 with respect to its domestic related parties in the taxable years ended September 30, [redacted] and September 30, [redacted][6]

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[4] These ambiguities were eliminated in later generations of the form.

[5] In our view, *In re Quality Medical Consultants, Inc.*, 192 B.R. 777 (Bankr. M.D. Fla.) is distinguishable from this case. In *Quality Medical Consultants*, the bankruptcy court sustained the taxpayer/debtor's objection to the Service's claim for penalties for failure to file and furnish information returns. However, the court noted both that the instructions to the form were confusing *and* that the corporate employee assigned to prepare and file the forms had no prior experience in doing so. The contrast between the facts of this case and the facts of *Quality Medical Consultants* could not be clearer. *See also Hansen v. Commissioner*, 820 F.2d 1464, 1469 (9th Cir. 1987), in which the court stated, in *dicta*, that imposition of the negligence penalty under former I.R.C. Section 6653(a) would not be appropriate "[i]f the taxpayer is 'misguided and unsophisticated in the realm of tax law,' and acts in good faith." We are prepared to assume, for purposes of this case, that [redacted] acted in good faith; however, it can hardly be characterized as "misguided and unsophisticated."

[6] We note that there is one other potentially meritorious argument that [redacted] failed to make, which would support a finding of reasonable cause with respect to one failure to file in each of the taxable years ended September 30, [redacted] and September 30, [redacted]

The Regulations provide that "[a] taxpayer may have reasonable cause for not treating a foreign corporation as a related party solely by reason of § 1.6038A-1(d)(3) (under the principles of section 482), and the taxpayer had a reasonable belief that its relationship with the foreign corporation did not meet the standards for related parties." Treas. Reg. § 1.6038A-4(b)(2)(iii) (last sentence).

With respect to the other failures to file, we do not believe that the facts set forth in support of [redacted] claim of "inadvertent administrative error," even if true, are sufficient to establish reasonable cause. In two instances, [redacted] failed to file Forms 5472 with respect to related parties for which it had filed Forms 5472 in prior taxable years. In our view, any person making a reasonable effort to comply with the requirements of I.R.C. Section 6038A would, as part of the process of determining whether Forms 5472 are required to be filed in any given taxable year, look at prior years' filings. There is no evidence that [redacted] did so. [redacted] apparent failure to do so negates any possible finding that the failure to file was based on a honest misunderstanding that was reasonable in light of [redacted] experience.

In addition, we do not accept [redacted] argument that the corporations in question were not known to be related to [redacted] so that it was not aware that it was transacting business with a related party. Like all distributors of branded goods, [redacted] and [redacted] zealously defend their trademarks and related intellectual property. In our view, the mere fact that the name of the other party to a transaction includes the word "[redacted]" creates a duty of inquiry. There is no evidence that [redacted] made the necessary inquiry. Accordingly, we cannot conclude that there was reasonable cause for the failure to file.

One of the domestic related parties, [redacted] is a corporation owned [redacted] percent by [redacted] and [redacted] percent by [redacted] which is not related to [redacted] or [redacted] Thus, [redacted] can only be a related party to [redacted] by reason of Section 1.6038A-1(d)(3). We are not aware of any principled reason why the last sentence of Section 6038A-4(b)(2)(iii) should not apply to domestic as well as foreign related parties. In our view, it would have been reasonable for [redacted] to believe that it is not related to [redacted] for Section 482 purposes–particularly in light of the fact that the Service has never asserted that [redacted] and [redacted] are related parties for Section 482 purposes.

CONCLUSIONS AND RECOMMENDATIONS

For the reasons set forth above, it is our opinion that the penalties asserted with respect to the failures to file Forms 5472 with respect to domestic related parties should be abated. We recommend that the $[redacted] in penalties asserted with respect to the failures to file Forms 5472 with respect to [redacted], and [redacted] not be abated.

If you have any questions regarding any of the matters discussed in this memorandum, please feel free to call Paul Burns of this office at (949) 360-3439.

JYB:PBB/pbb

cc: [redacted] Team Coordinator
Examination Group [redacted]

Ms. Donna Suarez, Appeals Officer
Southern California Appeals Office, Laguna Niguel